A SHORT HISTORY OF FEDERAL TAXATION IN AMERICA

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The taxation system of the USA has undergone a set of significant changes in reaching its present form. In the course of the relatively short history of the American nation there were periods of time during which citizens had been free from tax duties, but there also were spans when the burden of taxation had been growing rapidly.[1]

Americans, who during the colonial period strongly objected to any tax duties imposed by the British metropolis, were reluctant to accept taxes created for the sake of their own, independent state.

The first article of (I §8) of the Constitution which states that 'the Congress has the right to collect taxes, contributions and payments in order to pay off any debts and to ensure the common security and general welfare of the USA, whereas excise, levies and payments should be identical on the whole area of the USA (...) and (...) to issue all the acts, which turn out necessary and proper for executing all the above mentioned laws as well as all the other laws, which the present Constitution awarded to the central authorities of the USA or to their specific agencies and to their officials' was the legal basis for the development of fiscal legislature.

Initially, the inflow of money from customs duties was the main source of income for the federal government. In 1791, an indirect tax on alcoholic beverages (Excise on Distilled Spirits) was introduced. The level of the tax was varied and amounted to 25 cents per gallon of whiskey if the raw materials were imported and 18 cents per gallon if they were obtained domestically. The inspiration behind the introduction of this tax was U.S. Secretary of the Treasury Alexander Hamilton, which is why it was commonly known as 'the Hamilton tax'. The strong protest of Pennsylvanian farmers led to an outbreak of what has become known as the Whiskey Rebellion, which was suppressed by the US Army.[2]

In the following years several new taxes, which were reluctantly accepted by the citizens, had been established. These included: the Tax on Carriages, the Stamp Tax, the Tax on Land, the Tax on Dwelling Houses and the Tax on Slaves. In 1797, Congress established the first American tax on inheritance.

The War of 1812 provided the first indication of the connection between armed conflicts and an increase in fiscal duties. The financial means of waging the war were obtained by indirect taxation and excises. Both merchants and producers of monopolized commodities were required to purchase licences.

[1] J. Głuchowski, *Federalny system podatkowy Stanów Zjednoczonych Ameryki*, Toruń 1975, p. 16.

[2] J. Głuchowski, op.cit., p. 17.

The Mexican War of 1846 was an exceptional event in US history in that it did not cause an increase in taxation duties for the citizens. It was financed by long-term loans and by the revenues from customs duties.[3]

The financial policy of the federal government underwent radical changes during the Civil War years. The income obtained from customs duties and excises was not sufficient to cover the cost of the war. Initially, a direct tax was imposed on individual states (amounting to $20 million). Subsequently, taxes on a number of products (such as iron, tobacco, and whiskey) were increased. Still, revenues were not sufficient.

In 1861, Congress passed a bill introducing the income tax, at a rate of 3%. Only incomes of more than $800 per year were taxed. Very quickly the level of tax-free income was brought down to $600, and a rate of 5% was established for any income above $10,000. Two years later the rate was raised and the progression became faster. Any income between $600 and $5000 was subject to a rate of 5%, between $5000 and $10,000 to a rate of 7.5%, and any surplus over $10,000 was subject to a 10% tax rate.

In 1865, a 10% rate for income above $5000 was established. The tax remained valid even after the war had ended. The revenues from that tax were not big and in the period between 1863–1865 amounted to a total of $194 million.[4]

The end of the Civil War brought demands from citizens for the abolition of the taxes introduced during the war. The economy was developing dynamically. Existing tax duties were treated as a threat to this development and a violation of civil liberties. As a result, the Tax on Income and the Tax on Inheritance were abolished.[5]

In the 1870s and 1880s, reintroduction of the income tax had been proposed in Congress on a few occasions, but never was accepted.

It was finally reintroduced in 1894. A year later, however, the Supreme Court ruled that only the state authorities are legally allowed to impose the income tax, with the exception of when it is required for federal needs.

The nature of the argument lay in defining the powers of the Congress in the field of taxation policy. At the top of the list of legislative powers of this body is the right (Art. I. §8) 'to introduce and collect taxes, customs duties, contributions and excises in order to pay off any debts and ensure the common security and general welfare of the USA'. This source of income is understood to consist of four sections – the first one being direct taxation, the second and the third ones customs duties, and the last one being indirect taxation. The constitution defines two types of taxes – direct and indirect, and sets the principles for their introduction. According to Art.1 §9, the first type of tax, the direct tax, can only be introduced proportionally based on the population register. The second type, similar to customs duties and contributions, must be identical throughout the entire USA. In the light of the Supreme Court ruling in the case of Knowtton v. Moore (1900), 'uniformity' of indirect taxes implies that they must be measured on the same basis and set at the same level in every state. Nevertheless, this level does not need to be identical for all taxpayers.[6]

[3] W. Elliot Brownlee, *Federal Taxation in America*, Cambridge University Press, 1996, p. 21.

[4] J. Głuchowski, op.cit., p. 17.

[5] W. Elliot Brownlee, op.cit., p. 29.

[6] R. Małajny, *Pozycja ustrojowa Kongresu USA*, ZNUŚ, Katowice 1991, p. 68.

The judges of the Supreme Court had never had any serious doubts as to the nature of indirect taxation. The same cannot be said, however, about direct taxation. The task of defining what it was had been entrusted to the judges. The Supreme Court defined its attitude toward the problem for the first time in 1796, when it accepted that the only types of direct taxation are the poll-tax and the estate tax (Hilton v. United States). This attitude had remained for almost a century. When, during the Civil War, the Congress of the Union had imposed an income tax on its citizens (in the case of Springer v. USA (1881)), in its ruling the Supreme Court defined this as a direct tax. If it had not been introduced proportionally according to the population register results, it would have been in disagreement with the articles of the Constitution. In accordance with these conclusions, the Supreme Court introduced some amendments to the legislature and described the previous period as 'a century of error' (Pollock v. Farmer's Loan and Trust Co.). What is interesting here is the fact that the act in question levied a tax on any income of above $4000 per year, and the rate of taxation was barely 2%. Given the fact that the income tax cannot be levied and measured according to the population register, Congress had been deprived of this source of income for nearly 20 years.

In 1911, the judges of the Supreme Court adopted a slightly more relaxed attitude toward the problem, recognizing the income tax imposed on corporations not as a tax of the direct type, but as a kind of excise (Flint v. Stone Tracy Co.) All of this was decided two years later with the introduction of the 16th Amendment to the Constitution, which ruled that ' Congress has the right to impose and collect taxes from all sources of income and needs to consider neither the proportional distribution among the states nor the results of any kind of estimates and registers of population'. One might argue that this was the most important amendment introduced to the Constitution, because of its dramatic impact on the economy of the country.[7]

On Oct 3rd, 1913, President Wilson signed an act which was to be the basis for the first obligatory income tax based on the Constitution. Individuals subject to the income tax had to be well-to-do, and his or her income had to be higher than average. This resulted from the acceptance of the following principles: married men with an income below $4000 were eligible for exemption from the tax; for incomes of $4000–$5000 the tax rate was 1% and the highest rate of 6% was put into use when individual income had reached $500,000. Out of a population of 100 million, 368 000 families or individuals filled out the tax forms. In only 44 cases was the declared income more than $1 million. The revenues from taxation amounted to about $28 million, a lot less than had been anticipated at the time of the introduction of the act.

In the beginning of the 20th century, wars played an important role in the development of federal taxation. The outbreak of war in the summer of 1914 in Europe had started a new chapter in the history of taxation in the USA. On the basis of the ordinary acts of 1914, 1915, and 1916, the rates of the income tax were raised. The rate of the tax on legal entities, which had first been 1%, was now raised to 12%.

At the peak period of the First World War, a married man with two children and an income of $10,000 paid a federal income tax of $784. This was a 13-fold growth in comparison to 1913, when under identical circumstances the tax had been only $60. Expenses on the war effort demanded a substantial growth of revenues from

[7] R. Malajny, op.cit., p. 69.

the taxes collected by the federal government. In 1917 this income was $809 million, and in 1918 it shot up to $ 3699 million.[8]

In the 1920s, Andrew Mellon created a new financial strategy for the USA. Taxes were to be a stimulus for the dynamic growth of the economy. The upper rate of the income tax was brought down from 77% to 25%. Such a move was to reduce the instances of tax evasion and to make the system more rational. It turned out to have been a good decision. Despite the reduction of the tax rates, federal income had grown, and the economy of the country entered a period of prosperity.[9] In 1921, taxpayers with an income of more than $100,000 paid taxes amounting to 28% of total income; in 1926 the amount was 51%. Those in the lowest tax bracket, with incomes below $10,000, paid only 23% in 1921 and only 5% in 1926. The main cause for the shift in the tax burden was an attempt to move the financial means of the highest earners from tax-exempt obligations into productive investments.[10]

In 1924 the Board of Tax Appeals, which played a major part in the development of the system of taxation, had been created. It was reformed into the Tax Court of the United States and was established in order to rule out disputes involving gift and estate taxes. The rule that the taxpayer could not make claims before having paid the tax had been introduced. With the passage of time the Board of Tax Appeals was confirmed as an expert body and tax tribunal. Its decisions referred to compensation for taxpayers' damages, and its rulings often established precedents.

The end of the 1920s witnessed the crash of the stock market and the beginning of the Great Depression. The national income fell from $87.7 billion in 1929 to $42.5 billion in 1932. The revenues from the income tax fell as well. The period of the budget deficit had started. In this situation, Congress tried to raise the tax rate in order to maintain fiscal balance. After a long and heated debate the Revenue Act was passed in June, 1932.

The era of vivid legislative initiative had started. The principles of federal taxation had begun to change. In Congress, attempts were made at passing a new federal sales tax, but the proposal did not have sufficient support. A law passed in 1932 raised the tax rate for individuals with lower incomes. Rates for legal entities grew from 12% to 13.75%. Property tax rates grew as well. A gift tax was reintroduced, and a number of indirect taxes were established.[11]

The end of the 1930s and the period of the Second World War constituted another breakthrough period in the fiscal policy of the USA. In this period the income tax on natural persons became a common tax. The number of taxpayers grew continuously. In 1939 there were 4 million people paying taxes, in 1940 twice as many, and in 1941 the total was 17.5 million. As a result, every seventh person paid the income tax.

In 1939 the Codices of Internal Income, containing the rules concerning the taxation of citizens, was created. The tax-exempt income for married people was set at $2500 per year. A married man supporting two children was exempted from tax if his income was not more than $3000. The basic rate was 4%. A natural person with an income of $10,000 paid $343 and a legal entity with an income of $300,000 paid

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[8] J. Głuchowski, op.cit., p. 16.
[9] W. Elliot Brownlee, op.cit., p. 60.
[10] R.E. Hall, A. Rabuszka, *Podatek liniowy*, Łódź 1995, p. 36.
[11] J. Głuchowski, op.cit., p. 18.

$57,000 in taxes. In 1941 the tax-exempt income level was reduced to $1500 and the tax rates grew to 60% (with even higher rates as well).

In 1943, 40 million people paid the income tax, or one-third of the US population. A new 'Victory Tax' was introduced and a new form of payment was established. From now on the employer was obliged to deduct it from the wages.

With the progress of military success the costs of war began to decrease and taxation was beginning to be relaxed. On the basis of the Tax Adjustment Act of mid-1945, the rates were lowered. This happened again in 1948, raising the tax-free minimum from $500 to $600. The principle of separating the wife's income from that of her husband resulted in a drop in the tax rate. A similar rule was accepted with respect to the tax on property, tax on inheritance, and tax on gifts. The equal rights of ownership for husbands and wives entitled them to half of the given entity of each.[12]

The Korean War resulted in changes in the American system of taxation. The lowest rates were raised several times. The tax duties on legal entities were also increased. The income tax was applied to the earnings of writers, publicists, and composers. Congress also reintroduced the Excess Profit Tax.

New Codices of Internal Income were introduced in 1954. An efficiently functioning system of collecting and assessing income was created. Initially, this was called the Bureau of Internal Revenue; it was subsequently replaced by the Internal Revenue Service. In the mid- 1950s, the Internal Revenue Service employed 50,000 people and collected federal tax revenues totalling $66 billion. In 1955, 57,6 million natural persons filled out tax returns, as well as 836,000 legal entities. A total of 1,657,000 individual citizens and 153,000 legal entities' declarations had been controlled.

President Kennedy presented a new legislative initiative. He asked Congress to invest him with powers to reduce taxes in order to pull the country out of the recession. The president argued that an economy restrained by too many fiscal limitations could neither absorb the entire potential workforce nor provide satisfying profits and budget revenue. As a result, changes lowering the rates were introduced, bringing them from the range of 20–91% to 14–70% for most of the population.[13]

In 1969, Congress modified the income tax, bringing the upper limit to 50%. In the 1970s no significant changes that would have had any serious impact on the functioning of the fiscal system had been carried out.

I would like to pay more attention to the set of tax reforms introduced by Ronald Reagan. The basic legal acts which aimed at the reduction of rates and the simplification of the whole system were brought about by the Economic Recovery Act of 1981 (ETRA) and the Tax Reform Act of 1986 (TRA).

Passed on November 29, 1981, ETRA changed the principles of imposing taxes on individuals and corporations. The highest tax rates were lowered from 70% to 50% within just the first year of the introduction of the act. Indexes were created in order to avoid the shifting of incomes to higher tax rate brackets as a result of progressive inflation. Payments into pension funds together with interest rates were made tax-free. The upper limit of the tax on profits from capital were lowered from 28% to 20%. It was now possible to sign off charity donations without having to provide a detailed register of these donations.

[12] Ibidem, p. 21.

[13] R.E. Hall, A. Rabuszka, op.cit., p. 36.

Economic enterprise was to further the process of accelerating the cost recovery system (ACRS) by reducing the average time for deductions of devices from 8.6 years to 5 years, and for industrial plants from 23.8 to 15 years. Permission to use new forms of leasing had been granted and the range of tax allowances for investment mortgages for short-term use commodities was broadened. It was also stated that expenses for research and development purposes would not be taxed.[14]

A major budget deficit demanded changes to some of the main principles of the reform in order to obtain more budget revenue (Tax Equity and Fiscal Responsibility Act – TEFRA).

The tax Reform Act of 1986 was a legal document whose main task was to simplify and rationalize the US tax system. The authors of this project intended for the impact of TRA on the budget income to be neutral, i.e. that the amount of income obtained from lowering the personal tax would equal the amount of income obtained through the increased taxes on enterprises and possible savings gained as a result of further cuts in budget expenses.

Beginning in 1988, two new tax rates were introduced at 15% and 28%, as opposed to the previous rate of 14%. The effective rate of income tax on capital was increased to 28%. The rate for corporations was lowered from 46% to 40% in 1987 and to 34% over the following years. The period for recovery of cost deductions was shortened. The principles of tax allowance and tax-exemption were changed and, in many cases, abolished.

As a result, tax rates in the USA in the 1980s, especially for the highest income levels, were the lowest among industrialized, developed countries. Evaluation of this tax reform remains a topic of dispute among economists.[15] The main drawback is the increase of the budget deficit to an extent which threatens economic development. This was the first problem which presidents George Bush and Bill Clinton had to deal with. Reduction of the budget deficit defined the country's strategy with respect to fiscal policy in the 1990s. Five rates have been introduced at 15%, 28%, 31%, 36% and 39.6%, and the budget expenses have been firmly limited, which allowed for an unheard of budget surplus.

Favorable conditions in recent years have ensured increased revenues to the budget of the state and have prevented the necessity of raising tax rates. Creating a rational system of taxation is a crucial element in maintaining a stable rate of economic growth.

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[14] W. Bieńkowski, *Reaganomica*, PWN, Warszawa 1995, p. 157.
[15] Ibidem, p. 157.